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Problems and Priorities for the 1990 Federal Budget:

A Survey of Views from a C.D. Howe Institute Pre-Budget Workshop, January 26, 1990

edited by

William B.P. Robson

Introduction

The bringing down of a federal budget is always a key event in the Canadian economic calendar. In recent years, the event has been attended by an increasingly acute sense of apprehension because of the persistence of large deficits and the resulting rapid growth of interest payments on the public debt. The resulting pressure on the federal government's fiscal position raises several types of risks: that good programs will be slashed along with bad ones; that key considerations related to the tax system — efficiency, equity, competitiveness, and simplicity — may be overlooked; and that the deficit itself may be inadequately contained, condemning Canadians to run around the same vicious circle of rising debt and interest payments through the 1990s as well.

It was with these concerns foremost that the C.D. Howe Institute convened a pre-budget workshop on January 26, 1990, inviting a number of leading economists to share their opinions on the key issues surrounding the budget. This *Fiscal Policy Monitor* presents a survey of the views of workshop participants. Its purpose is to highlight areas of consensus and disagreement among experts, in the hope of increasing Canadians' understanding of the challenges facing federal fiscal policy.

It should be emphasized at the outset that the views reproduced here are those of the workshop participants, and not necessarily those of the Institute or its members. The Institute's views on federal fiscal priorities have been set out in *Getting It Right*, Policy Review and Outlook, 1990, and in its pre-budget submission, "The Key Elements of a Sound Fiscal Strategy," copies of which are available on request.

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C.D. Howe Pre-Budget Workshop

Participants (clockwise from left)

Surinder K. Suri, Chief Economist, London Life Insurance Co.
William B.P. Robson, Policy Analyst, C.D. Howe Institute
Lloyd C. Atkinson, Senior Vice-President and Chief Economist, Bank of Montreal
Warren Jestin, Vice-President and Chief Economist, Bank of Nova Scotia
Philip D. Howell, Senior Economist/Manager, Bank of Nova Scotia
Ernest Stokes, Director of Canadian Services, The WEFA Group
John A.G. Grant, Director and Chief Economist, Wood Gundy Inc.
Donald J. McIver, Chief Economist, Sun Life Assurance Company of Canada
George Vasic, Chief Economist, Data Resources of Canada
Satya Poddar, Tax Advisor, Financial Services Group, Ernst and Young
Irene K. Ip, Senior Policy Analyst, C.D. Howe Institute
Edward A. Carmichael, Senior Economist, Burns Fry Ltd. (not in picture)

Summary

In assessing the government's record since 1984, participants generally expressed disappointment about the slow pace of deficit reduction and the government's tendency to resort to tax increases rather than spending cuts in efforts to reduce the shortfall. Looking ahead to priorities in the budget, a large degree of consensus emerged on the need for substantial expenditure cuts. Business subsidies were most frequently mentioned; a number of participants expressed concern, however, about cuts in development assistance and transfers to the provinces. The group felt that in view of the heavy tax burden already borne by Can-

adians, the budget should avoid tax increases — although the excise tax on gasoline was mentioned as a possible exception.

Participants stressed the necessity for a firm, credible, deficit-reduction plan. Disagreement was evident, however, in terms of both the timetable for reduction and the desirability of special temporary measures related specifically to containing the growth of interest costs. The group discussed a number of risks to the fiscal outlook, with higher-than-expected interest rates receiving the greatest amount of attention. Some comments highlighted the potential for lowering the burden of interest charges through lengthening the maturity of the government's debt.

Although most participants observed that the government's difficulties stem in large part from uncoordinated fiscal and monetary policies, there was little support for the view that the Bank of Canada should ease its policies in order to relieve the fiscal pressure. More prevalent was the view that a firm anti-inflation policy holds the best hope for getting interest rates and debt-service charges down.

Finally, the group expressed a desire for more, and more clearly presented, information in the budget. Not all participants were convinced that better fiscal policies would result, but many felt that Canadians would benefit if the ability of analysts and voters to understand — and to plan on the basis of — the government's intentions were increased by more comprehensive accounting of the present and future costs of various programs.

* * * * *

Main Issues Addressed

The Federal Fiscal Policy Record since 1984: Successes and Failures

Satya Poddar:

Finance Minister Michael Wilson's greatest achievement has been to convince the Prime Minister and his cabinet colleagues of the critical nature of the fiscal situation. It took Wilson five years — so you may call him a failure in the sense that it took him so long, or you may call him a success in that he finally did it. Wilson came to the Finance portfolio with a fairly clear understanding of the seriousness of the fiscal situation and why some action had to be taken, but he got virtually no support in his first four years from the Prime Minister's Office.

Most of the expenditure cuts made over the past 4 years were in the portfolios of Treasury Board and Finance. Federal-provincial transfer payment cuts were entirely the Minister of Finance's responsibility. Holding back growth in operating expenditures was Treasury Board's responsibility. Every time Treasury Board and Finance looked for some expenditure room, they succeeded only in cutting programs within their own portfolios.

Lloyd Atkinson:

As I look at the numbers, the government now faces a problem of the same order of magnitude that it thought in 1984 would be horrific. It worried that we would be hamstrung by debt; that debt-service costs would be monstrous. The government in many ways now finds itself in the kind of box that it was afraid of if Trudeau had remained in power and if it had continued down that fiscal path. From that perspective, we would have to say that the track record since 1984 has been terrible.

In addition, although in 1984 all the emphasis was put on getting ourselves out of this box by cutting expenditures, in point of fact what the government has done is largely pull the tax lever. Up until the last budget they had about a 50-50 split on expenditures versus taxes. In the last budget they just threw away all pretense of expenditure restraint as the principal tool of deficit control. It was about 77 percent on taxes versus 23 percent on expenditure. And what is not even in those calculations yet, for 1991, is the additional $2.3 billion in taxes that comes about from the use of the GST [Goods and Services Tax] to fund a new expenditure program — namely, income redistribution.

George Vasic:

The government was warned right from day one about the smoke and mirrors in its early exercises. It talked a lot about the extent to which expenditure cuts were going to be part of the total deficit-reduction program. The smoke and mirrors part was that it was tax increases which lowered the deficit, which then lowered subsequent debt and interest-payment loads — so when you got to the end of that five-year period in the 1990/91 fiscal year, you got most of the hit on the expenditure side.

Unfortunately, the government has not followed through with any conviction on what it said, and that is the reason that we are sitting around this table with this problem. I think issues of coordination of monetary and fiscal policy are important, but had the government done its their part earlier, we wouldn't be looking at the kind of situation we're facing right now — where we're looking at a number in the low 30s as a baseline with risks into the upper 30s if things don't go well into 1990.

Ernest Stokes:

I'll be a little kinder to the government. We can divide a discussion of fiscal policy into microeconomics and macroeconomics. Microeconomics is structural change and macroeconomics is stabilization policy, though there is some overlap. If we look at the microeconomics side of the balance sheet, I think the government is moving in the right direction — free trade, getting rid of the FST [Federal Sales Tax]. Macroeconomic policy in terms of stabilization policy: there are obviously a lot of problems there. Has fiscal policy been procyclical? I would argue that it has. Why did we get tax cuts in 1988? Did we need tax cuts in 1988? No, we got tax cuts in 1988 because there happened to be an election that year. We had 5 percent growth in the economy — why did we need tax cuts? You can't only blame the federal government: if you look at the Ontario government, you didn't exactly have countercyclical fiscal policy there either.

Satya Poddar:

In terms of the biggest failure, one thing that they could have done differently was the GST. The government was ready to implement the BTT [Business Transfer Tax] in 1985. The BTT was very simple in design, very comprehensive, neutral, without any distortions — and the rate was surprisingly low. If the government had implemented the BTT or the GST at that point in time, it would be in a lot better shape from a fiscal point of view. What we have today is a tax that is complex in design, and the complexities will get worse over time, because it is not comprehensive and watertight. And on top of that, because the government didn't sell it very well, it will have a very difficult time increasing the rate in the next two or three years. As a result, the government doesn't really have the fiscal room that it was hoping that it would get with the GST.

Priorities on the Spending Side

Surinder Suri:

There are lots of people who say "Not mine — the other fellow's." But I think the expendi-

ture side is where it has got to come. If you are looking for how to cut immediately in fiscal 1990/91, but with effects that would continue in a medium-term and a long-term perspective, the two big areas have got to be health care and education. And what should we do with regional development programs?

Ted Carmichael:

This is the hardest question to answer every year. It was easier to answer in 1984, when deficit cutting began, than it is in 1990. The easy and obvious things were cut in the first two budgets after 1984. Since then, it has gotten more and more difficult to find major items that would significantly reduce the deficit. The government has to look across the board. I think that some spending programs that in the past have been considered politically too dangerous now need to be looked at.

The government has made a start on social programs with the clawback; now it may have to reduce the threshold income level at which the clawback takes effect. The government should do whatever it can to reduce business subsidies. Most of these subsidies are on a contract basis and therefore can't be stopped overnight, but the spending should be phased down. I think with the changes in the world situation over the last few months, some cuts in defense spending should be there. I tend to agree with External Affairs Minister Joe Clark that we shouldn't cut more from development assistance at the present time — that took the biggest hit last year.

The key point, however, is that over the medium term, expenditures will only be held in check if interest rates are considerably lower than they are today, and interest rates will only be lower if inflation is considerably lower than it is today. If interest rates could be brought down through a continued tough monetary policy — for as long as it takes — then you could be talking about billions of dollars lower on the deficit, rather than a couple of hundred million here and a couple of hundred million there.

John Grant:

Like Ted, I think we are facing an extremely volatile situation in the countries of the world outside the G-7. Eastern Europe, the Soviet Union, Africa, and South America are all being forced to come to terms with rules of the game that they really haven't lived by. Those are not light transitions, so I think the case for foreign assistance of one kind or another remains a very strong one — I would be on Joe Clark's side.

Other transfers within our own country, though, are definitely candidates for cutting. Subsidies to the business sector are long overdue for further restraint. Support for agriculture, too, would be one of our candidates.

Don McIver:

I would not like to see more sloughing off of responsibilities on the provinces in this budget. We need to focus more on the federal, provincial, and municipal aspects of this. What worries me is not just the impact on the fiscal balance of each level — if you slough it off on the provinces and the provinces slough it off on the municipalities — but a situation where you have a decentralization of government in a country which doesn't have the size to maintain the number of jurisdictions that it has.

One of the things that the federal government has failed to do during its term is to sit down with the provinces and decide what type of social programs are required in this country and how they can be funded. Until we can combine some of those programs and focus on true national priorities, we're going to end up with a continued fiscal mess.

Priorities on the Revenue Side

Warren Jestin:

Further tax increases must be avoided. If the GST rate is raised, the "temporary" surtaxes that have become imbedded in the tax

structure must be eliminated. According to Ottawa's own estimates, general government revenues in Canada are already a significantly higher proportion of national income than in the United States. They are well above the average for the G-7 economies. The high tax environment in Canada, in my view, is taking away the potential benefits that could arise from the Free Trade Agreement.

In addition, raising indirect taxes adds to price inflation, and the ongoing erosion of personal disposable income by tax increases fuels wage inflation. For example, recent settlements in the textile industry and Quebec's public service have built-in GST escalators. The inflationary bias of recent tax initiatives limits the room for an easing in monetary policy and a reduction in short-term interest rates.

Lloyd Atkinson:

I know that making international comparisons is difficult, but according to the Department of Finance's own projections for 1990/91 — and this does not include the additional $2.3 billion in taxes from the GST — we are looking at total tax revenue of all governments in Canada as a percentage of GDP about 20 percent higher than the United States and about 10 percent higher than the OECD average. And even if you were to subtract out a health-care-cost component, because that is borne by the governments here and by employers south of the border, you are still looking at a tax burden about 10 percent higher than the United States. It strikes me as though the government has absolutely no room to maneuver on taxes.

Don McIver:

Revenue priorities should center on assuring the implementation of the GST. To this end, a comprehensive public education program should be put into play. To date, Canadians poorly understand the nature of the tax. Their ignorance is likely to be reflected in unjustified demands for offsetting wage increases and by unwarranted price increases. Both phenomena risk exacerbating inflation.

John Grant:

I'll put the excise tax on gasoline on the table. I think that one is a good candidate for an increase on environmental grounds.

The Deficit Strategy

Satya Poddar:

My concern is that cutting expenditures by a billion or two, or doing something on the revenue side, will not really buy you peace. Leaving aside interest charges, current revenues are quite adequate to pay for the programs we have now. The problem is an overhang from the past. So what we need is a very dramatic, fundamental change, which is explicitly tied to reduce the debt.

Because we have a capital problem, as opposed to a flow problem, the government could take measures that are discrete in nature, and do not lead to unnecessary compromises in the design of ongoing expenditure programs and revenue systems that are functioning well — and could be sustained without the overhang of accumulated debt. Any expenditure cuts or revenue increase designed to reduce the debt should be subject to a definite, non-extendable, sunset clause.

One of the questions that needs to be explored in this context is: Who should bear the fiscal burden of such overhang correction measures? That is, how should the burden be distributed? Should the distribution of this burden be the same as that of the existing revenue and expenditure programs?

It could be argued that because the overhang requires a stock correction, it should not affect flow variables — e.g. consumption or incomes — and that it should be based on capital, wealth, or other such nonflow variables. The measures could also involve a temporary

freeze on certain expenditures. In that process, the government will not distort the design of programs simply to deal with the deficit crisis, nor will it create programs that become permanent features of our system well after the crisis has gone.

George Vasic:

It's true that if you look at our primary, non-interest picture, we now have a surplus, the highest amongst the G-7 nations. But the hard part about a one-time hit to get rid of the deficit and the debt is that the hit is going to be so large that the multiplier effects — which you could argue may not be so big on small adjustments — are certainly there. There is also the risk that you introduce temporary measures which then become permanent.

We have to remember that there is a great domino effect on the debt and interest costs. We still can get a balanced budget by the end of the 1990s, if we keep current taxation policies in place, real program spending at about one percent growth and some moderate decline in interest rates over that period. And it doesn't take much to get it into a surplus position. I've mentioned this in a corporate setting and people think this is incredible, but that's what the arithmetic clearly shows.

Warren Jestin:

I have three comments here. First, taking away slices of people's assets is probably the best way of scaring off capital in this country that I've ever heard. Second, I think the idea of freezing expenditure is a great one, but I don't think you can do it for a one-year period — it would have to be a multiyear program. And shooting for a balanced budget by the end of the 1990s is much too long a time horizon, simply because you are adding each and every year to the debt.

By the government's own estimates, in 1994 it is expecting to pay out $40 billion in interest. You are caught in a situation where, if you don't get the deficit down very quickly, you are continuing to add to this interest bill. It's no wonder the government finds its policies unpopular now: as the C.D. Howe Institute pointed out, you're paying a dollar to the taxman but getting less than a dollar in services. Each and every year you're getting less for every dollar paid. I think we should get the adjustment over much more quickly.

Don McIver:

The most significant fiscally responsible action that the government can take in the budget would be to reaffirm its commitment to stabilizing the ratio of public debt to GDP in the 1990/91 fiscal year. Specifically, this means that the ratio in the first calendar quarter of 1991 will be no higher than the current ratio. Roughly, this would require a budgetary deficit in the order of $25 billion.

Quite frankly, there's no point arguing that the government needs to put in front of us a serious schedule of developments over the next three, five, ten years, when you all know that it is going to come back with another budget before then. So I would say: Let's have a first step — stabilizing that ratio.

It is essential that the objective be accompanied by a set of economic and fiscal projections that is credible — even conservative. Moreover, a commitment must be given that stronger-than-expected economic, price, or revenue growth will be translated into additional deficit reduction — while underperformance will trigger additional restraint. Five of the seven key OECD countries have already achieved this goal. Canada shares with Italy the unhappy position of nonconformity.

Major Risks and Possible Responses

Satya Poddar:

We should start by noting that there are a number of things that the government has not

budgeted. If you look at the government announcement of December 19, when it calculated the revenue impact of reducing the GST from 9 to 7 percent, they did not factor in the one-time rebate of $1,000 for small businesses. The cost of that program alone is $1 billion. Along with revenue losses from the refund of the FST on inventories and slower remittances of the GST than of the FST, the government will face a revenue shortfall of at least $3 billion, possibly $4 billion, in the first year of GST implementation. Finance must be trying very hard to find ways of offsetting this one-time revenue cost of the GST.

Surinder Suri:

I want to say in very strong terms that if this is not perceived as a responsible budget internationally, notably in Japan and the United States and to some extent in Germany, as well as here, it seems inevitable to me that two consequences would arise. One would be a massive exchange-rate crisis. Second, it would leave no room for the Bank of Canada to lever rates down. A lot of our debt is short-term, so that will add to interest costs and we may not be looking at $34 or $35 billion — it might be a good deal higher. So I think the federal government has to show effective leadership.

Lloyd Atkinson:

I suspect that Michael Wilson has got to be pretty nervous, given what has been happening in financial markets over the last few days. If we were to price the bank rate today at noon hour, we would have wiped out the 29 basis-point reduction that was given away a short eight days ago and we also find ourselves with a Canadian dollar that is significantly weaker. This all puts the Bank of Canada in a real straitjacket.

We all remember 1986, and if we get the financial markets or the business community trashing this next budget, we are likely to find ourselves in a bit of an exchange crisis again. Now, I would expect it would be temporary, but nonetheless it's something that I would think that Mr. Wilson and company would not look forward to with relish.

George Vasic:

Obviously, higher interest rates — higher than they are planning in the budget — are the major risk to the fiscal outlook over the near term. The question is: What can we do about that? In my own view, we have to leave monetary policy to do its job. One answer that is workable in a context of unchanged monetary policy is to extend the average maturity of federal debt, which, as of November, was under four years. We're now paying an unduly high penalty for very high short-term interest rates.

I think we would be well served to issue debt in the three- to five-year range — where we can enjoy a saving of 2 or 2 1/2 percentage points on interest payments. This might be worth easily a billion dollars in year one. We can get the savings now and still be able to capitalize on the lower interest rates that should be available in the medium term.

Ted Carmichael:

I would support what George is saying. The government ought to be shifting down the yield curve, financing less with treasury bills and more with mid- and long-term bonds. If new medium-term issues start pushing up 3- to 5-year interest rates, then they don't have to keep piling it on — the term of new bond issues is not something that needs to be decided in the budget.

Over the course of the past year, the government has had to finance almost its entire financial requirement through treasury bills — in other words, the bonds that it has issued have just offset the Canada Savings Bonds that have run off. It's been advised many times that it should shift the balance more towards the medium or even the long end

of the curve to take advantage of the lower rates. The government seems reluctant to do it, but I think that should be part of the program.

Warren Jestin:

The politics of the situation work against you because if you move out the yield curve, you are locking in a higher deficit, whereas if you double up on your bet that interest rates are going down, at least you can project a lower deficit.

Coordinating Fiscal and Monetary Policy

John Grant:

I think that the game plan has been laid out by the government — if you consider the government to include [Bank of Canada Governor] John Crow. Disinflation must be part of this strategy. Our guess is that a half percent a year off the GDP deflator is the minimum deceleration of inflation that would lead financial markets to continue believing that there is some credible strategy in progress. That will bring us down to between one and two percent on the deflator by fiscal year 1993/94. I think it is not unreasonable under the circumstances, assuming control of program expenditures along the lines anticipated, that we would get the budget close to balance by then.

The interesting question is just how much of a deflationary gap we have to open up to get that decline. If we have a serious recession in order to get inflation down, then of course we do have to recognize that the impact on the deficit will be to make us once again worse before we're better — and then dramatically better — later. In our own view, the disinflationary gap that is going to be required is substantially milder than the one that we went through from 1982 to 1987. We think we are in a mild recession now, but we are hopeful that it will remain mild, and after a very weak year in 1991 we will see rapid growth in 1993 and 1994.

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Warren Jestin:

I think we are going through a period of turbulence that we haven't seen in recent years, simply because both monetary and fiscal policy are now hamstrung by the string of events [a temporary reduction in short-term interest rates accompanied by a steep slide in the dollar] that has occurred in the last week or so. High interest rates certainly raise the deficit, but they are not the cause — in my view, they are the consequence of the deficit problem. As for waiting for a period of disinflation to click in to allow interest rates to come down, I think we will be waiting a long time for inflation to drop to levels that international markets will find acceptable enough to allow the interest-rate structure to drop without causing dislocation in the exchange-rate market.

Ernest Stokes:

I think a lot of the government's problems have to do with the coordination of fiscal policy and monetary policy, especially the use of tax policy. Should you use stagflationary policies such as indirect tax increases when you're trying to reduce inflation? Last year, right when the Bank of Canada was trying to reduce inflation, indirect tax rates were jacked up. Well, that does reduce growth, but it also increases the price level. If you're going to reduce the deficit, it's better to use deflationary policy such as a decrease in expenditures or an increase in income taxes.

Improvements in Budget Presentation

Phil Howell:

Certainly, people's ability to plan is adversely affected when you have a budget process that delights in obfuscation. I think you find business people, voters, individuals — and most people in government, outside of the Treasury and Finance departments — somewhat uncertain as to where things are going. That's one of the biggest costs in the current budget process in Canada.

At a more specific level, we have to get the information out in — for lack of a better word — an honest manner. Ottawa should provide greater detail about the expected impact of fiscal initiatives on its finances and the economy. The smoke-and-mirrors approach of lumping large dollar expenditures under "reserves net of lapse," or one-time shifts in spending or revenues between fiscal years, must be avoided.

Better information in terms of the true cost of programs would allow a more educated debate than the kind of system that we have right now. I find it difficult to believe that we'd be in as bad shape as we are today if people two or three years ago had been able to look at the overall government fiscal plan.

Ted Carmichael:

The Ministry of State for Social Development has developed measures of the total value of social programs for various groups in society. These measures add together the spending programs, the credits, and all the various tax programs that go to the elderly, and the same thing for youth and a number of other groups. That kind of presentation is obviously available within the government. But nobody else gets that information. I'm sure it's easy for the government to put it together, and it would be useful to have in the budget.

Warren Jestin:

There is other information that should be made available. For example, the accounting profession has been suggesting for some time that CPP [Canada Pension Plan] unfunded liabilities be included. That's about $350 billion, and there's an explicit future tax cost related to that. Unless this information is widely disseminated, unless the public is aware that the overall cost of doing business is going to go up on a year-over-year basis through a variety of decisions that are taken by government, they're not going to have the information needed either to support or to deny a specific set of policy initiatives.

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"[Finance Minister] Wilson should sit down and read the policy review issued by the C.D. Howe Institute this week....The economic think-tank dispassionately tries to gauge how far away he is today from a sustainable long-term fiscal track." — Nate Laurie, *The Toronto Star*

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